

SOME ASPECTS REGARDING THE PERFORMANCE INDICATORS USED IN THE MANAGEMENT OF A COMPANY

Popa-Lala Ion

West University, Faculty of Economics and Business Administration

Aniș Cecilia – Nicoleta

West University, Faculty of Economics and Business Administration

To assess the economic performance of an enterprise four indicators are commonly used: return on investment, residual income, economic value added and profitability of sales.

The performance analysis is a constituent of any managerial control system. Strategic planning and control decisions require information on how different subunits of the enterprise worked. To be efficient, performance indicators and remuneration have to motivate the managers and the employees from all enterprise levels and to make sustained efforts to implement strategies and to attain business objectives.

Key words: performance, profitability, economic value added, investments

JEL classification: M, M2, M21.

1. Introduction

Although it is a frequently used term, the concept of performance is seldom defined clearly, its meaning being considered as implicitly known .

A definition, translated from English, explains the term "performance" as, among other things, "the proportion/extent to which an investment is profitable²⁹⁶."

Extending this definition, one can consider that firm management is efficient if it is able to generate profits or it is advantageous, useful, noting that profit does not necessarily mean a financial plus, but meaning a gain, a benefit, or the converted form of capital gains, that is to say that it can be of various kinds: financial, social, human, environmental, etc. Therefore, performance can be interpreted as the gained profit, namely the result of the action and performance evaluation as the realized gain assessment.

The information about the performance of an institution is needed in order to assess potential changes of the economic resources which the entity will be able to control in the future, to anticipate the ability to generate cash flows with the present resources, to formulate judgments about how efficiently it can engage and use new resources.

In practice, financial performance information is provided primarily by "the profit and loss account", respectively by the budget execution account, but things are not as simple as to reduce them to the synthetic data in a particular periodic reporting form because it would be a pity to ignore the information in real time the account book provides. Performance is more important than money. Money reflects a possession, performance expresses the ability to capitalize the possession.

2. Performance measurement from financial perspective

Performance measurement is part of any managerial control system. Strategic planning and control decisions require information on how different subunits of the company worked. To be efficient, performance indicators and remunerations should motivate the managers and the

²⁹⁶ Judy Pearsall, *The Concise Oxford Dictionary*, Tenth Edition, Oxford University Press, New York, 1999, p.1060.

employees at all business levels and make a sustained effort to implement the strategies and to achieve the business objectives.

A variety of performance indicators are based on internal financial information. Businesses supplement more and more the internal financial indicators with indicators based on:

- external financial information (eg. the stock);
- internal non-financial information (eg. Product fabrication time, the number of new patents, the rate of flaws);
- external non-financial information (market share, customer satisfaction).

These indicators are often compared to those registered in other subunits of the same companies or other businesses.

In some companies financial and non-financial performance indicators registered by their subunits are presented in a single report called balanced scorecard. In the balanced scorecard²⁹⁷ the enterprises record various elements, but most scorecards include:

- indicators of profitability;
- customer satisfaction indicators,
- internal indicators of efficiency, quality and time;
- innovative indicators.

Some performance indicators, such as the number of patents, have a long-term time horizon. Others, such as efficiency deviations of direct raw material, have a reduced time horizon. In this article we will refer to the most commonly used performance indicators, covering a medium to long-term time horizon They are internal financial indicators based on accounting data of an enterprise.

To assess the economic performances of an enterprise four indicators are commonly used.

Some companies record high levels of the profit made from operating, but the question is whether they are the most advanced.

The main weakness of making comparisons on the sole basis of profits from operating is that this way one ignores the differences between the volumes of investment in each firm. Investments refer to resources or assets deployed to achieve profits. There is no question of how much is the profit made from operating, but how much is the operating profit compared to investments made to obtain it.

Three of approaches regarding performance measurement include also an indicator of investment: return on investment, residual income and economic value added.

The fourth approach, the profitability of sales, does not include an investments measure indicator.

2.1. Return on investment

Return on investment (ROI) is a book value of profit divided by a book value of investments:

Return on investment (ROI) = Profit/ Investments

Return on investment is one of the most common ways to measure performance, and this for two reasons:

- combines all the elements of profitability - revenue, costs and investment - into a single indicator;
- can be compared with the rate of return opportunities from other parts.

ROI is also called accounting rate of return or cumulative accounting rate of return. Managers usually use the term "ROI" when assessing the performance of a subunit and the term "cumulative accounting rate of return" when an ROI indicator is used to evaluate a project.

²⁹⁷ C.T. Horngren, S.M. Datar, G. Foster, *Contabilitatea costurilor, o abordare managerială*, Ediția a 11-a, Ed. Arc, 2006, p.858.

Some companies prefer to use operating profit in the denominator, others prefer to focus only on assets financed by a long-term debt, using total assets minus current liabilities.

Businesses may increase ROI through increasing revenue or through lowering costs, through reducing investments. ROI can clearly define the performance issues when it is determined by its components:

$\text{Profit/investments} = \text{Profit/income} * \text{Income/investments}$

or

$\text{ROI} = \text{Return on investment} \times \text{number of investment rotation}$

This approach is known as DuPont method of profitability analysis. This method identifies the two basic ingredients in making a profit: increasing the proportion of profit from each leu income and mobilizing assets to generate higher revenues. Improvements in a component without changing the other component will generate an increase in ROI.

ROI sets out clearly the benefits the managers can obtain by reducing assets investment or fixed assets investments. Some entrepreneurs are aware of the need to increase revenue or reduce costs, but pay little attention to reduce the investment base. Reduction of the investment base means good credit management, reducing the amount of idle cash, setting appropriate levels for stocks and the mobilization with high attention to the long-term assets.

2.2. Residual income

Residual profit (RP) is an accounting measure of profit minus a value expressed in lei of the required return on investment.

$\text{Residual profit (RP)} = \text{Profit} - (\text{Required rate of investment} \times \text{Investment})$

By multiplying the required rate of return on investment to investment value is obtained imputed cost of investment. The imputed costs are costs identified in certain situations which usually are not reflected in financial accounting systems.

Some companies prefer RP, because managers will focus on maximizing the absolute value, such as RP expressed in RON and not on a percentage, as the ROI. The objective of maximizing the RP means that, while a subunit records a return that exceeds the required rate of return on investment, that subunit activity should be extended.

The objective of maximizing the ROI might determine the very profitable subunit managers to reject the projects which, in company's view as a whole, should be accepted.

Matching goals (ensuring that division managers are working towards achieving company goals) is more easily achieved using PR and not ROI as an indicator of the division manager performance.

2.3. Economic value added

Attaining the major objective of the company, maximizing the overall value can not be achieved, but by creating value within firms. The overall performance is defined according to the company's ability to create value to its holders of interests, eg. shareholders, creditors, employees, suppliers, local community etc. Of course, company shareholders prevail, who are in fact the owners. Managers appointed by these must constantly seek to achieve this objective by permanently creating value.

Performance indicator most commonly used for assessing the growth in value of the enterprise is the economic value added.

Normally, a company should not reinvest the net profit, but if its future investment projects are capable of generating a higher return rate than the rate of fructification of capital market for comparable risk projects.

Otherwise, the net profit should be distributed as dividends to shareholders or redemption of own shares. Investors will be able to capitalize the amounts received at the obtained market return from the financial assets of similar risk.

As the main problem of any performance indicator of a title based on the issuer profit, beyond a possible "creative" handling, is not taking into account the cost of capital used by the firm in the analyzed period, a more accurate measure could - be considered to take account of this element, comparing it with the return obtained.

The concept in this way is called Value Based Management (VBM). Accepting the assumption that business value is directly dependent on the future financial flows generated by the firm, conceptual VBM, becoming in time a real philosophy of doing business, acknowledges that a company generates value in excess in time only if its capital investments will have a higher return than the cost of capital.

VBM is used by many leaders of companies as a way of managing them and through which to generate an additional value for shareholders

VBM appeared initially and experienced a tremendous development in the United States, giving rise to a managerial philosophy which enforces the managers for un the companies so that the shareholder wealth (whose first constituent is the amount of shares) to increase over time. So it is put emphasis on the interests of business owners unlike some earlier approaches, common in many European countries, according to which the interests of employees, customers, suppliers and the public ones were considered at least as important. The harsh reality of capital markets globalization, evidenced by international corporations access to formerly protected markets, the more increasing competition in high technology and resource control, the major acquisitions, takeovers and mergers between leaders of economic sectors have led to rapid spread of this philosophy in Europe too, it being understood, accepted and required in Western Europe economies. Based on this philosophy running a company it have been developed various concepts and methods to allow detection of capital gains made in past times and to provide valid criteria for selecting investment projects for horizontal or vertical development.

The best known alternative concept, based on the central idea that there is no real income if one does not exceed the cost of capital used, is that one launched by U.S. firm Stern Stewart: Economic Value Added, in short EVA.

“EVA” - *Economic Value Added* or economic value added is the most famous and one time, the most publicized performance indicator in the speciality press.

The economic value added has become in the decade 1990 - 2000 a quality standard of company's total, a performance indicator of the management team, a reference in foundation and assessing the efficiency of decisions.

The reasoning underlying this indicator is simple and logical: equity, like borrowed capital, has a specific cost. Unlike the cost of borrowed capital, which appears explicitly in the profit and loss account, the cost of capital, expressed by compensation set to investors, has a different accounting treatment.

To create value, the company must earn enough to cover both the cost of financial debt and the opportunity cost of capital. Also, bear in mind that pay equity must be at attractive rates, in any case higher than that the investor could obtain in case of a risk-free investment. Economic value created by an enterprise during a period should take into account not only the amount recorded in the accounts, but also the opportunity cost of capital.

Cost of capital is a concept useful for management company helping it in the selection of alternative investment projects and allowing the development of strategies to optimize the financial structure of the company, respectively the optimal proportion between the medium and long-term, the capital consisting of preference shares and ordinary share capital formed. Optimization goal is to minimize the cost of capital of the business used on the market and to perceive profitability of the capital providers and company specific risk and, ultimately, the firm's accessibility to different forms of financing. Minimizing the cost of capital used by the firm has a direct impact on maximizing business value through minimizing input regarding the financing operations carried out.

Economic value added is a specific model calculation of residual profits which lately gained considerable importance. Economic value added (EVA) is equal to operating profit after tax minus the weighted average cost(after tax) of capital multiplied by total assets minus current liabilities.

Economic value added = Operating Profit after tax - [weighted average cost of capital x (Total Assets - Current Liabilities)]

Economic value added substitute the following figures in residual income calculations:

- profit is equal to operating profit after tax;
- required rate of return equals the weighted average cost of capital after tax;
- investment equals total assets minus current liabilities.

Total assets less current liabilities may also be calculated as:

Total Assets - Current Liabilities = Fixed assets + Current assets - Current liabilities = Current assets + Working capital

Where:

Working Capital = Current Assets - Current Liabilities

Economic value added, and residual profit, are costs associated with investments in long-term assets and working capital. The value is created only if the operating profit after tax exceeds the cost of capital investments. To improve the EVA, managers should:

- record operating profit after tax higher with the same capital;
- to raise less capital to achieve the same operating profit after tax;
- the capital to be invested in projects with high profitability.

Managers of firms use the estimated impact on EVA to take certain decisions. The division managers consider EVA useful because it allows them to use the cost of capital to take decisions at the division. The comparison between the actual and estimated EVA is useful for performance evaluation and for obtaining feedback on performance managers.

2.4. Return on sales

The relationship between profit and income (or sales), also called return on sales (RS) is a financial indicator of performance. RS is a component of the ROI in DuPont profitability analysis method.

Some companies record high levels of RS, but their performances are considered to be lower than other companies performances using indicators such as return on investment, residual income and economic added value.

3. Conclusions

The role of financial management consists in the task it has to use various instruments which ensure an adequate protection against risks At the same time, financial management aims at maximising the company value, not only with reference to its own capitals, but also to the future investment and projects which the company's equity will be engaged in.

The wealth accumulated by a company at a given moment is only one of the elements that allow for the appreciation of its value. We must also take into account the results expected in the future, as a result of using the accumulated equity.

Consequently, the company value is a value anticipated in that it takes into account the current value, which is correlated with the forecast future revenues obtained from the company's activities. For this reason, the company value cannot be separated from the quality of the projects its equity is engaged in.

Mastering all the means and tools in achieving the major objective of financial management, namely to maximise the company value, based on its performance, emphasises the important role played by financial management at company level.

To assess the overall performance, return on investment indicators, residual income and economic value added are more suitable than the profitability of sales because these take into account both the profits made and the investments.

ROI identifies the investment with the highest profitability. The EVA and RP indicators help solve problems of matching the goals generated by the ROI. Some managers prefer EVA, because it takes into account tax issues, while RP before tax does not include these considerations.

Other managers prefer RP before tax, because it is easier to calculate and because, in most cases, leads to the same conclusions as EVA.

Taking into account the practices of companies, it is noted that companies use multiple financial indicators to evaluate performances.

References

1. Buglea, A.& Lala Popa, I. (2009), *Analiză economico-financiară*, Timișoara:Mirton Publishing.
2. Băileșteanu, Gh.(1998), *Diagnostic, risc și eficiență în afaceri*, Timișoara:Mirton Publishing.
3. Burz ,R .D.(2010), *Teză de doctorat Evaluarea performanței managementului întreprinderii*, Timișoara.
4. Horngren,C.T.& Datar, S.M.&Foster,G. (2006) *Contabilitatea costurilor, o abordare managerială*, Chișinău: Arc Publishing.
5. Iosub-Dobrica, F. (2008), „Shareholder Value Enhancing Strategies – Empirical Evidence on Multinational Corporations Behaviour”, *Annals of the „Alexandru Ioan Cuza” University of Iași*, issue 55: pp.65-75.
6. Niculescu, M. (1997), *Diagnostic global strategic*, București: Economic Publishing.
7. Pearsall, J.(1999), *The Concise Oxford Dictionary*, , New York: Oxford University Press.
8. Văduva, F.& Duca, I. & Gherghina, R. (2009), “ Maximizing Company Value – An important objective in financial management”, *Annals.Economic Sciences Series*, issue XV:pp. 665-668.